*United States Court of Appeals*

*for the Second Circuit*

# APPELLANT'S BRIEF

7

# 75-4211

# United States Court of Appeals

## FOR THE SECOND CIRCUIT

**Docket No. 75-4211**

NORMAN and ARLENE RODMAN, MARTIN and PHYLLIS RODMAN, ESTATE OF ROBERT RODMAN, Deceased, GERTRUDE RODMAN, Administratrix and GERTRUDE RODMAN, ESTATE OF SYDNEY NEWMAN, Deceased, DOROTHY NEWMAN, Executrix and DOROTHY NEWMAN, Surviving Spouse, ESTATE OF SYDNEY NEWMAN, Deceased, DOROTHY CLIFFORD NEWMAN, Executrix and DOROTHY CLIFFORD NEWMAN, Surviving Wife,

*Appellants,*

B

P/S

—v.—

COMMISSIONER OF INTERNAL REVENUE,

*Appellee.*

ON APPEAL TO REVIEW DECISIONS OF THE UNITED STATES TAX COURT

## BRIEF FOR APPELLANTS


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*Appellants,*

—v.—

COMMISSIONER OF INTERNAL REVENUE,

*Appellee.*

## BRIEF FOR APPELLANTS

### Statement of Issues Presented for Review

I. Can the Joint Venture include a $900,000 debt (or, in the alternative, the value of a May 1956 obligation—the Tax Court would not accept testimony as to that value) in the basis of Torbrook stock it bought and sold during 1956?

II. Are the appellants entitled to 1956 deductions for loss carrybacks of their respective adjusted capital interests from 1958 (when the Joint Venture concluded)?

III. Is $250,000 paid to the Joint Venture in 1956 by General Tire and Rubber Company taxable as long-term capital gain?

IV. Is the IRS precluded from retroactively taxing appellant Martin Rodman on Joint Venture income attributable to the period before he became a venturer?

V. If it is ultimately determined that Norman Rodman, Martin Rodman, Robert Rodman and Sydney Newman had unreported 1956 income from the Joint Venture, are appellants Arlene Rodman, Phyllis Rodman, Gertrude Rodman and Dorothy Clifford Newman "innocent spouses" relieved of liability for attributable taxes and interest pursuant to Internal Revenue Code § 6013(e)?

VI. Should the Joint Venture's contested 1956 and 1957 business deductions be partially allowed pursuant to the rule of *Cohan* v. *Commissioner*, 39 F.2d 540, 2 USTC ¶ 489 (2d Cir. 1930)?

The appellants contend that the correct answer to each of the above issues is "YES". The Tax Court disagreed with that contention.

## Statement of the Case

This appeal involves Federal income tax liabilities determined by the United States Tax Court in the following amounts:

| *Appellants* | *Years* * | *Deficiencies* |
|---|---|---|
| Norman Rodman ("Norman") and Arlene Rodman ("Arlene") | 1956 | $193,029.85 |
| | 1957 | None |
| Martin Rodman ("Martin") and Phyllis Rodman ("Phyllis") | 1956 | 198,852.64 |
| | 1957 | None |
| | 1959 | 7,660.00 |
| | 1960 | 3,319.00 |
| | 1961 | 694.48 |
| | 1962 | 4,081.58 |
| Estate of Robert Rodman ("Robert"), Deceased, Gertrude Rodman ("Gertrude") Administratrix, and Gertrude Rodman | 1956 | 199,365.79 |
| | 1957 | None |
| Estate of Sydney Newman ("Sydney"), Deceased, Dorothy Clifford Newman ("Dorothy"), Executrix and Dorothy Clifford Newman ** | 1956 | 358,892.73 |
| | 1957 | 782.24 |

* 1957 is involved because of carryback and carryforward computations. 1959 to 1962, inclusive, are involved because Martin is entitled to loss carryforwards which were not allowed by the Tax Court.

** Please note that in some of the Tax Court pleadings Dorothy Clifford Newman was referred to as Dorothy Newman.

The trial was held before the Honorable William H. Quealy, Judge of the United States Tax Court, on October 10, 16 and 17, 1972. The Decisions of the Tax Court being appealed by the appellants were entered on July 7, 1975. Those Decisions were based upon a consolidated Opinion filed on December 19, 1973 (T.C. Memo. 1973-277, 32 TCM 1307) and a June 2, 1975 hearing where the appellants' proposed computations for Decisions were rejected by the Tax Court. A Notice of Consolidated Appeals to this Court was filed on September 18, 1975.

The parts of the Tax Court Decisions being appealed by the appellants relate to:

(1) the Tax Court's failure to include a $900,000 debt (or, in the alternative, the value of a May 1956 obligation) in the basis of Torbrook stock purchased and sold by the Joint Venture in 1956;

(2) the Tax Court's failure to allow the petitioners loss carrybacks of their respective adjusted capital interests from 1958 (when the Joint Venture concluded) to 1956;

(3) the Tax Court's determination that $250,000 paid to the Joint Venture in 1956 by General Tire and Rubber Company was not taxable as long-term capital gain;

(4) the Tax Court's determination that Martin Rodman's share of the Joint Venture's alleged 1956 income exceeded .03558—*i.e.*, that he could be retroactively taxed on income attributable to the period before he became a venturer;

(5) the Tax Court's determination that the four female petitioners are not entitled to "innocent spouse" relief pursuant to § 6013(e) of the Internal Revenue Code of 1954, as amended ("Code");

(6) the Tax Court's failure to allow the Joint Venture 1956 and 1957 business deductions pursuant to *Cohan* v. *Commissioner*, 39 F.2d 540, 2 USTC ¶ 489 (2d Cir. 1930), and

(7) the Tax Court's failure to allow Martin and Phyllis Rodman loss carryforwards to 1959, 1960, 1961 and 1962.

## Facts

Norman and Arlene Rodman, Martin and Phyllis Rodman, Robert and Gertrude Rodman, and Sydney and Dorothy Clifford Newman were, respectively, husbands and wives at all times pertinent herein. Robert Rodman, father of Norman and Martin, died on September 29, 1969. Sydney Newman died on June 30, 1963. T.C. Opinion, p. 9.

At the time of the filing of the petitions with the Tax Court all of the individual appellants were legal residents of the State of New York. For purposes of determining venue on appeal, the residences of the Estates of Robert Rodman and Sydney Newman, which are represented by legal representatives, were also the State of New York. T.C. Opinion, p. 9.

The Joint Venture commenced operations in 1955 when Sydney, Robert and Norman entered into a joint business relationship with Walter Ornstein ("Ornstein"). Each party then received a 25 percent interest therein. Partnership returns for the Joint Venture were filed on the accrual basis of accounting for 1955, 1956, 1957 and 1958. The returns were prepared by Mr. Norman Elliott. T.C. Opinion, pp. 9 and 10; T.C. Tr. 295, 300; T.C. Exs. 21-U, 22-V, 23-W and 24-X.

Norman Elliott has been a Certified Public Accountant since 1937. He is admitted in the States of New York

and Pennsylvania. He is also a member of the bars of New York and the United States Southern District Court of New York. He has been a member of the ruling body of the American Institute of Certified Public Accountants; a Director and Executive Committee member of the New York State Society of Certified Public Accountants; and a Department Editor of the *Journal of Accountancy*, the accounting profession's national publication (T.C. Tr. 292 and 293).

The principal activity of the Joint Venture during 1955 was an attempt to get control of a A. M. Byers Co., Inc., a listed corporation. In 1956 the Joint Venture was engaged primarily in the purchase and sale of stock of Torbrook, a Canadian company. T.C. Opinion, p. 10.

Torbrook was incorporated in early 1956 to promote prospecting licenses issued by the Minister of Mines, Nova Scotia. 1,900,000 Torbrook shares were originally issued to Henri Leroux, Aurele Brisson, Sydney and various nominees for the following consideration (T.C. Opinion, p. 10):

| | | *Consideration* | |
|---|---|---|---|
| *Shares* | | *Total* | *Unit* |
| 900,000 | Henri Leroux | Mining Licenses | |
| 500,000 | Aurele Brisson | $100,000.00 | $ .20 |
| 100,000 | Sydney | 125,000.00 | 1.25 |
| 100,000 | Sydney | 200,000.00 | 2.00 |
| 100,000 | Sydney | 250,000.00 | 2.50 |
| 135,485 | Sydney | 406,455.00 | 3.00 |
| 64,515 | Various Nominees | 13,247.34 | .20 |

Except for the Leroux shares, the Joint Venture acquired virtually all of the above Torbrook shares during 1956. It then sold 835,055 Torbrook shares to the public for $2,574,903.34. T.C. Opinion, p. 11. The Tax Court's

failure to allow a proper basis for 500,000 of those shares is the main issue in this case.

Facts relevant to the specific issues presented by the appellants for review are as follows:

### (1) The $900,000 Debt

During 1956 the Joint Venture acquired the 500,000 Torbrook shares originally issued to Aurele Brisson. The pertinent issue is whether $900,000 accrued by the Joint Venture as part of the purchase price of those 500,000 shares was improperly excluded from the Joint Venture's basis by the Tax Court.

Mr. Brisson was a Montreal attorney (T.C. Opin., p. 11) who, unfortunately, died on January 20, 1970 (T.C. Stip., par. 18). His sale of the 500,000 Torbrook shares to the Joint Venture (which was acting through Robert) was made pursuant to a May 1956 letter agreement addressed to Mr. Brisson, which provided as follows (T.C. Opinion, p. 12; T.C. Ex. 42):

> "You have agreed to sell me [Robert, for the Joint Venture] five hundred thousand (500,000) shares of * * * Torbrook * * * for Twenty-one Cents ($0.21) per share *and* for and in the further consideration that I will transfer to you, without cost, twenty per cent (20%) of any additional shares of the capital stock of Torbrook * * * which I may acquire, * * * ." (Emphasis added)

The May 1956 agreement between Mr. Brisson and the Joint Venture came to the attention of Mr. Elliott in September, 1956. Due to the ambiguous and open-ended nature of the 20% provision, Mr. Elliott suggested that a fixed $900,000 liability be substituted. Mr. Elliott was concerned about the difficulty of interpreting the 20% commitment and the tremendous cost that might result on

the volume of transactions contemplated by the Joint Venture. He was requested to draft a substitute agreement. T.C. Opinion, pp. 12 and 13.

Mr. Elliott then drafted a novation agreement with the $900,000 fixed obligation as a substitute for the May 1956 obligation (T.C. Tr. 317). The substitute agreement and its accompanying Note, each of which were executed on November 3, 1956, provide as follows (T.C. Exs. 38 and 43):

"November 3, 1956

"Aurele Brisson, Esq.
10757 Grande Allee
Montreal, Que.

"Dear Mr. Brisson:

By agreement last May, I undertook to transfer to you, without cost, twenty per cent (20%) of any additional shares of the capital stock of Torbrook Iron Ore Mines Limited which I might acquire in addition to the shares sold by you to me, and further subject to any escrow agreements restricting our receipt or possession of the shares.

We have since acquired, incuding the rights to purchase Leroux stock in escrow, approximately 1,000,000 shares of which 900,000 has not as yet actually been stock available to us.

You know, and we know that problems of mining, company control and general money requirements to see Torbrook off to a really good start may take as much as four years. We therefore wish you to cancel that agreement, and instead, accept a non-interest-bearing note for $900,000 from us, with a due date of November 15, 1960. We agree to advance you sums of money from time to time, at our discretion and within our financial means, in partial and earlier payment of this note,

and will settle any remainder on the final due date specified.

On your part, and in return for this settlement, you agree not to purchase or sell shares of Torbrook Iron Ore Mines Limited during that period and to do nothing that would prejudice the position of that company or ourselves with respect to the market position of that company's stock, or its finances or ours, and that you will not in any way profit, directly or indirectly, from the company's operations or dealings except upon our express written prior consent. Any violation of this undertaking, however trivial, shall operate to cancel the unpaid balance of the note.

We herewith hand you the note and request that you indicate your acceptance of the above terms and the note by your signature below.

Very truly yours,

/s/ ROBERT RODMAN
Robert Rodman, as agent for himself and associates

Accepted:

/s/ A. BRISSON
A. Brisson"

"900,000.00 November 3, 1956

November 15-1960 after date I promise to pay to

the order of Aurele Brisson

Nine hundred thousand 00 Dollars

at 40 West 57 St. NY City

Value received No interest.

No. Due November 15-1960 /s/ ROBERT RODMAN

The $1,005,000 which the Joint Venture agreed to pay to Mr. Brisson for the 500,000 Torbrook shares ($105,000 under the May 1956 Agreement (T.C. Ex. 42) and the $900,000 substitute obligation under the November 3, 1956 novation agreement (T.C. Ex. 43)) was a better buy than the 435,485 shares which Sydney purchased for $981,455. Though not yet paid, the $900,000 debt has never been cancelled (T.C. Tr. 283).

The Tax Court made a factual finding that there was a May 1956 Joint Venture agreement with Mr. Brisson (T.C. Opinion, p. 12). Included in the record of the case are that agreement (T.C. Ex. 42), the November 3, 1956 Joint Venture-Brisson agreement (T.C. Ex. 43) and the $900,000 note (T.C. Ex. 38). Despite that finding and these documents the Tax Court held (T.C. Opinion, pp. 38 and 39):

> "In order to properly accrue the liability in question, the burden rested on the petitioners to establish that there was an unconditional obligation to pay one Aurele Brisson the sum of $900,000 as of the close of the taxable year 1956. *United States* v. *Anderson*, 269 U.S. 422 (1926). The petitioners have failed to meet that burden."

It is submitted that the above holding is clearly erroneous and not supported by the evidence. The joint venture should be permitted to include its $900,000 debt (or, in the alternative, the value of its May 1956 obligation) in the basis of Torbrook stock it bought and sold during 1956.

## (2) Loss Carrybacks and Carryforwards

On March 19, 1957, pursuant to a Complaint filed by the Securities and Exchange Commission, the United States District Court for the Southern District of New York enjoined Robert, Sydney and (by the Court's ex-

tension of the Judgment to "agents") the Joint Venture from selling Torbrook shares (T.C. Ex. 49). In 1958 the Joint Venture sustained a huge loss, became inactive and the appellants' interests in the Joint Venture became worthless (T.C. Tr. 41, 300; See IRS admission on Tr. p. 4 of the Tax Court's June 2, 1975 hearing).

The appellants submitted proposed Tax Court Rule 155 computations which took into account 1958 losses which, due to partnership interest basis adjustments generated by the 1956 liabilities (See IRC § 705(a)(1)(A)), should be carried back to reduce the alleged 1956 liabilities. The IRS Rule 155 computations, which were adopted by the Tax Court, did not take those losses into account. The following excerpts from the June 2, 1975 Tax Court hearing on the contested Rule 155 computations are pertinent to this issue:

*Tr. 3 and 4*:

> "The Court: * * * now let's take your position here. You say the joint venturers were permanently enjoined by the Securities and Exchange Commission from trading in the securities of Torbrook Iron Ore Mines, Limited. Said securities became worthless in 1958 and was so recognized by the respondent for the year December 31, 1958 as a joint venture ordinary loss and a net operating loss carryback. Is that correct, Mr. Goldstein [IRS Counsel]?
>
> Mr. Goldstein: Your Honor, the record will show that the parties stipulated to a joint—I mean, jointly stipulated to a net operating loss for each of the joint ventures in 1958. The basis of that determination of the net operating loss was that the remaining basis in the stock which the partnership or the joint venture was trading in did become worthless.
>
> The Court: All right.

* * * * *

The Court: Well then, what are we arguing about, Mr. Shurman?

Mr. Shurman: In addition to the loss to the joint venturer (sic), since the—each capital interest of the partners—of each partner became worthless. Under the statute, each partner is entitled to deduct a part—the loss of their capital interest and—on my contention that it is an ordinary loss, it can be carried back and if I can carry it back to '56, that will eliminate the '56 deficiency."

Tr. 9:

"The Court: Well, they might have had a minus basis.* *They had these losses.* And number two, the cases that you cite are the pre '54 cases. The Court would have to rule that if there were a loss here, it was a capital loss. (Emphasis added)

Mr. Shurman: May I ask Your Honor on what basis would you determine it to be a capital loss?

The Court: Because it's my understanding that that's the law as a result of the '54 amendments.

Mr. Shurman: I don't see any—anything in the '54 code that would change the nature of the—

The Court: Well, that may be where you and I differ, but——

Mr. Shurman: Well—

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* IRC § 705(a)(2) provides that partnership interest basis decreases shall *not* go "below zero". See *Falkoff*, 62 T.C. 200 (1974).

The Court: —that's the same partnership provisions that we're dealing with here, which I'd be the first to admit are lacking in clarity, but since neither you nor I had any part in the drafting of them, why we can say that freely. But I think you've got at the two problems, as I say. Number one, you can't start out by saying you had a basis of a million three. We don't know what it was.

Mr. Shurman: If the Court finds that's the income in 1956, there's your starting—there's your starting point."

Tr. 16 and 17:

"The Court: * * * I think I'll have to enter the computations—decision based on the computations as submitted by the respondent. I was hoping, maybe, that we could find some figure that we could agree on, so that——

Mr. Shurman: If the respondent—

The Court: —the figure would be in the record in the event—

Mr. Shurman: If the respondent has a figure—

The Court: —that you should appeal and the case be remanded. But, actually, since—in that event, we're not only going to have to find out what the basis is, but we may have to find out how much is ordinary loss and how much is a capital loss, *I guess the remand would almost necessarily entail a new trial anyway, so we'll just hope and pray.*" (Emphasis added)

Tr. 18:

"The Court: Well, we'll let that stand then. I'm sorry, Mr. Shurman, but I just don't see how we can do anything else here. It's—you may—*the whole case may be wrong. I don't know.* I see that it—

Mr. Shurman: Well, I'm—

The Court: —it provoked a lot of writing backwards and forwards and so forth and *I wish you luck on appeal and maybe then we can find out what these partnership provisions mean,* because—" (Emphasis added)

Tr. 20:

"Mr. Shurman: But isn't there a possibility that in the foreseeable future—

The Court: Well, I think maybe *you might just as well wait till remand anyway, Mr. Shurman.*

Mr. Shurman: Okay.

The Court: I mean, then we'll have to face it, if necessary.

So——

Mr. Shurman: That's the point I wanted to bring out.

The Court: And I'm sure you're going to appeal and I hope you do. As I say, *I'd like to see the Court of Appeals take a look at these partnership provisions and maybe this is a circuit of heavyweights up here, maybe they can give us—give us some guidance here. So—*" (Emphasis added).

It is submitted that (1) ordinary losses were sustained by the venturers in 1958 of their adjusted capital interests, (2) those losses can be carried back to reduce the alleged 1956 income, and (3) for Martin, his unused 1958 loss can be carried forward to 1959, 1960, 1961 and 1962. The Tax Court's failure to deal with the loss issue was a substantial error of law.

### (3) The $250,000

The $250,000 paid to the Joint Venture by the General Tire and Rubber Company (the "Company") concerns the following facts:

(a) On June 22, 1953 James J. Sunday filed patent application #363362 with the United States Patent Office for a pump (T.C. Ex. 28-AB; T.C. Supp. Stip., par. 13).

(b) On August 7, 1953 Sydney purchased Mr. Sunday's rights in the patent application (T.C. Ex. 28-AB).

(c) On September 22, 1953 Sydney transferred three 1/4 interests in the patent application to Robert, Norman and Ornstein (T.C. Ex. 28-AB).

(d) During 1955, when the Joint Venture attempted to acquire control of A. M. Byers Co., Inc., it engaged in a proxy fight with the Company and eventually lost, having incurred a total of $380,677.23 in proxy expenses (T.C. Opinion., p. 21).

(e) On July 3, 1956 the Company and the Joint Venture (acting through Sydney and Norman) entered into the following agreement (T.C. Supp. Stip., par. 5; T.C. Ex. 26-Z):

"WHEREAS, the Shareholders [the Joint Venture] own or control 25,000 shares of Common Stock of A. M. Byers Company ("the Shares") * * *

WHEREAS, the Company is contemplating making an offer to holders of Common and Preferred Stock of Byers and the Shareholders are willing as hereinafter set forth to agree to deposit or cause to be deposited the Shares in acceptance of such offer by the Company, and

WHEREAS, the Shareholders have informed the Company that they claim reimbursement against Byers for approximately $380,000 which they represent to have been expended by them in connection with solicitation of proxies and other matters relative to meetings of shareholders of Byers, and

WHEREAS, the Shareholders own or control all of the right, title and interest in a certain pending United States patent application with respect to a rubber bellows pump which the Company desires to acquire.

NOW, THEREFORE, in consideration of the mutual promises and covenants and the performance of the acts herein provided for, it is agreed as follows:

1. The Shareholders agree to deposit or cause to be deposited as hereinafter set forth the Shares in acceptance, if made, of an offer by the Company to acquire Common Stock of Byers, if such offer is made to holders of Common Stock of Byers on or before October 1, 1958, provided that such offer includes, among others, the following terms and conditions:

(a) The exchange by the Company (subject to provisions in lieu of issue of fractional interests) of one share of its Cumulative Preference Stock (par value $100 per share) and a warrant to purchase one share of its Common Stock for each 3-1/3 shares of Common Stock of Byers, * * *

2. The Shareholders represent that the Shares are now in the custody of banks or brokerage firms (which members of the New York Stock Exchange) in New York State, whether by reason of pledge or otherwise. The Shareholders agree that they

will as soon as practicable issue irrevocable written instructions to such banks or brokerage firms directing each of them to execute and deliver, within 10 days after the above offer of the Company is made, a Letter of Transmittal in the form supplied by the Company, consistent with this Agreement, accepting the exchange offer with respect to the number of shares of Byers Common Stock in the custody of each such bank or brokerage firm, and to deliver such shares to the First National City Bank of New York, the Exchange Agent acting on behalf of the Company, against delivery of the securities to be issued by the Company in exchange therefor.

* * * * *

4. The Shareholders hereby assign, and have caused to be delivered herewith assignments by other persons of, all of the right, title and interest of the Shareholders and such persons in and to pending United States patent application number 363,362 (filed June 22, 1953 by James J. Sunday and assigned on August 7, 1953 to Sydney Newman, such assignment being recorded on August 10, 1953 in the U.S. Patent Office, Liber A237, at page 207) with respect to a rubber bellows pump, a copy of which application and information relating thereto have been delivered to the Company, and the Shareholders represent that no other persons own any right, title or interest in and to such application. The Shareholders each further agree to execute and cause to be executed any and all documents deemed necessary by the Company effectively to assign to it the above-mentioned application and patent issued as a result thereof and to cooperate fully in the prosecution thereof.

* * * * *

> 7. The Company agrees, within three business days after the receipt of executed letters, in the form attached hereto as Exhibit C, from the banks and brokerage firms referred to in paragraph 2 hereof and covering all of the Shares, to pay to Sydney Newman and Norman Rodman jointly the aggregate sum of $250,000; and such payment of $250,000 (except as stated in the next sentence) shall not be refundable to the Company even though the offer referred to in paragraph 1 is not made by the Company or does not become effective. * * *"
>
> (f) On July 17, 1956 the executed letters referred to in paragraphs 2 and 7 of the July 3, 1956 Agreement were furnished the Company and the Company paid the $250,000.00 to the Joint Venture (T.C. Supp. Stip., pars. 6 and 7). The 25,000 Byers shares were then exchanged for Company stock and warrants pursuant to paragraph 1(a) of that Agreement (T.C. Supp. Stip., par. 8).
>
> (g) Further amendments to the patent application were filed by the Company in October 1956 and June 1957 (T.C. Supp. Stip., par. 13).

The Company paid the Joint Venture the $250,000 for (i) all rights to the patent application for the rubber bellows pump and (ii) the subsequently exercised option to purchase 25,000 shares of A. M. Byers Co., Inc. An allocation of the $250,000 was not necessary since long-term capital gain applies to each item. The Tax Court's holding that the $250,000 was taxable in its entirety as ordinary income is based upon a substantial error of law.

## (4) Retroactive Taxation

On November 2, 1956 Ornstein sold his 25% interest to the three remaining venturers, Norman, Robert, and

Sydney and withdrew from the Joint Venture (T.C. Ex. 39). The interests of the remaining joint venturers were then 33-1/3% each. On November 5, 1956 Martin joined the Joint Venture (T.C. Tr. 266) and the interests of the venturers from that date forward were as follows: Sydney, 1/3; Robert, 2/9; Norman, 2/9; and Martin, 2/9 (T.C. Ex. 41). It was Martin's understanding that he was to assume his share of the profits and losses *from that time forward* (T.C. Opinion, p. 32; T.C. Tr. 246, 266 and 267).

Since Martin obtained a 2/9 interest in the Joint Venture on November 5, 1956, his arithmetic percentage interest for 1956 is .03558 (57/366 x 2/9). The Tax Court's widely-publicized holding that Martin should be *retroactively* taxed on 2/9 of the Joint Venture's entire alleged unreported 1956 income is contrary to applicable Regulations and is based upon a substantial error of law. If that holding is allowed to stand, promoters of so-called "tax shelters" will use it as a precedent in their attempts to defeat the revenue with devious retroactive loss schemes—schemes designed to avoid taxation of the rich and further shift the tax burden to middle-income wage earners.

## (5) Innocent Spouses

The alleged respective amounts of unreported 1956 Joint Venture income determined by the Tax Court are far in excess of 25 percent of the amounts of gross income stated in the 1956 joint returns filed on behalf of Arlene, Phyllis, Gertrude and Dorothy for the periods involved (T.C. Exs. 1-A, 6-F, 12-L, and 18-R).

Those spouses were not members of the Joint Venture. They neither knew nor had reason to know of the alleged omissions when they signed their returns (See T.C. Tr. 242) and they had no significant benefits from said alleged omissions.

These women should be protected by Code Section 6013(e) from the Tax Court's appallingly harsh result. The legislative intent behind § 6013(e) contemplated the exact situation presented herein: two widows and two spouses who (i) had nothing to do with the pertinent financial transactions and (ii) are being taxed on respective 1956 deficiencies (excluding interest) of $193,029.85, $198,852,64, $199,365.79 and $558,892.73.

The Tax Court's November 13, 1973 Order refusing to open the record for testimony from the spouses (they were unavailable, sick and aged in October 1972) was harsh and improper. The Tax Court's holding that, regardless of testimony, § 6013 cannot apply under the circumstances herein is a substantial error of law.

### (6) Joint Venture 1956 and 1957 Business Deductions

Disputed Joint Venture 1956 and 1957 deductions are as follows (T.C. Opinion, pp. 27-30, incl.):

| | *1956* | *1957* |
|---|---|---|
| Sales Expenses | | |
| Claimed | $124,804.19 | $40,793.90 |
| Disallowed by IRS | 124,804.19 | 40,276.38 |
| Travel and Investigation | | |
| Claimed | 9,445.56 | 7,688.98 |
| Disallowed by IRS | 6,685.73 | 7,688.98 |
| Commissions | | |
| Claimed | — | 2,700.00 |
| Disallowed by IRS | — | 2,700.00 |
| Legal and Accounting | | |
| Claimed | — | 64,053.88 |
| Disallowed by IRS | — | 61,117.88 |

When Mr. Elliott prepared the Joint Venture's 1956 and 1957 returns he carefully checked the substantiation for all of the above items (T.C. Tr. 301-306, incl.). Those

documents and records were compiled and cross-indexed for examination by IRS agents during 1958 and 1959 (T.C. Tr. 310).

Most of the records were subsequently lost during repeated investigations and because of deaths (Tr. 310). In view of those circumstances, the Tax Court's failure to invoke *Cohan* v. *Commissioner*, 39 F.2d 540, 2 USTC ¶ 489 (2d Cir. 1930), to allow at least part of the disallowed amounts is a substantial error of law.

# ARGUMENT

## ISSUE I

### The Joint Venture can include a $900,000 debt (or, in the alternative, the value of a May 1956 obligation) in the basis of Torbrook stock it bought and sold during 1956.

The Tax Court held that the appellants failed to establish that the $900,000 debt was accruable. That holding is contrary to the evidence and clearly erroneous because the record discloses "that a mistake has been made". See *Tulia Feedlot* v. *United States*, 513 F.2d 800, 75-2 USTC ¶ 9522 (5th Cir. 1975).

During 1956 the Joint Venture was buying and selling Torbrook shares. It sold 835,055 shares to the public for $2,574,903.34. Those shares represented the major portion of 1,000,000 originally issued Torbrook shares acquired by the Joint Venture as follows: (1) 500,000 shares purchased directly from Torbrook by Sydney and various nominees for $994,702.34 and (2) 500,000 shares purchased from Mr. Aurele Brisson. The Tax Court determination sustained the incredible IRS theory that the latter 500,000 shares—shares sold for more than

$1,500,000 (a unit price of over $3.00)—could have been purchased for a mere $105,000 (a unit price of 21¢).

The Brisson shares were purchased in May 1956 for $105,000 *plus* the obligation to transfer 20% of additional Torbrook shares acquired by the Joint Venture. Since the obligation to transfer 20% of "additional" Torbrook shares appeared to extend to all purchases in market-making transactions, it was considered onerous by Mr. Elliott and he recommended that a $900,000 fixed obligation be substituted for the May 1956 open liability. His recommendation was implemented and a novation agreement was entered into with Mr. Brisson on November 3, 1956 and the $900,000 note was given to him.

1956 was the proper year for accruing the $900,000 debt. See *Lawyers' Title Guaranty Fund* v. *United States*, 508 F.2d 1, 75-1 USTC ¶ 9252 (5th Cir. 1975). The May 1956 agreement was the event which generated the liability and the November 3, 1956 novation agreement's conversion of that open-end liability to a fixed figure (i) satisfied the requirement that the amount of an accrued liability must be determinable with reasonable accuracy (Reg. 1.446-1(c)(ii)) and (ii) was consistent with the IRS policy that claims to receive indefinite amounts should be valued for Federal income tax purposes. See Rev. Rul. 58-402, C.B. 1958-2, 15.

Purchase-money debt is included in cost. *Crane* v. *Commissioner*, 331 U.S. 1, 47-1 USTC ¶ 9217 (1947); *Manual D. Mayerson*, 47 T.C. 340 (1966). Where an accrual taxpayer's debt is represented by a note, the face amount of the obligation is the basis taken into consideration. See *Sacramento Medico Dental Building Co.*, 47 B.T.A. 315 (1942); *Time Oil Co.* v. *Commissioner*, 258 F.2d 237, 58-2 USTC ¶ 9769 (9th Cir. 1958); *Evwalt Development Corp.*, T.C. Memo. 1963-56, 22 TCM 220 (1963); *Wasatch Chemical Co.* v. *Commissioner*, 313 F.2d 843, 63-1 USTC ¶ 9305 (10th Cir. 1963).

*Merlo Builders, Inc.*, T.C. Memo. 1964-34, 23 TCM 185 (1964), involved a situation similar to the issue at hand. In that case the Tax Court dealt with IRS suspicions by summarizing the facts and the law as follows:

> "For its taxable years ended October 31, 1955 and 1956, Builders deducted, as part of the cost of goods sold, $6,300 and $24,570, respectively, as additional costs of the real estate sold during those years. This additional amount of $30,870 has not been paid and is shown as a liability on the books and records of Builders. Vesta deducted, as part of the cost of goods sold, $15,600 and $15,000 for its taxable years ended November 30, 1956 and 1957, respectively, as additional costs of real estate sold in those years. This additional amount has not been paid and, on the books and records of Vesta, the $30,600 is shown as a liability.
>
> * * * * *
>
> Respondent has allowed as cost of land purchased by Builders and Vesta the cash paid out at the time of acquisition but had denied as a cost of the land purchased the liability set up on the books of Builders for $30,870 and on the books of Vesta for $30,600. * * *
>
> Petitioners, on the other hand, allege that a liability arose out of the purchase of the 100 lots in question, and that a case for the existence of such liability, reflected in accrual to cost of land, has been established by them.
>
> We agree with petitioners' position and accordingly allow the items in question as additional (accrued) costs of land."

The crux of both the *Merlo Builders* case and the issue now before the Court is the IRS refusal to accept the

application herein of *Crane, supra, i.e.*, that accrued liabilities are part of cost even though the liabilities are not paid during the audit period. That refusal is contrary to the established principle that such liabilities do enter into cost. See Landis, "Liabilities and Purchase Price", 27 *Tax Lawyer* 67, 70. As the Tax Court noted in *David Bolger*, 59 T.C. 760 (1973), though the *Crane* doctrine can produce "a bitter pill" for the IRS, there is "no way of sugarcoating that pill, short of overruling *Crane* * * *".

Aurele Brisson did *not* sell 500,000 Torbrook shares for $105,000. He sold them for $1,005,000 and the $900,000 debt was properly included in cost. The Tax Court's elimination of the $900,000 or its May 1956 obligation from the Joint Venture's basis should be reversed.

## ISSUE II

**The appellants are entitled to 1956 deductions for loss carrybacks from 1958. In addition Martin is entitled to carry forward his unused 1958 loss to 1959, 1960, 1961 and 1962.**

The Tax Court's December 19, 1973 consolidated Opinion held that the Joint Venture's 1956 income was substantially understated. The IRS Rule 155 computations adopted by the Tax Court in its July 7, 1975 Decisions divided the alleged additional 1956 Joint Venture taxable income in distributive shares as follows:

| | |
|---|---|
| Sydney (1/3) | $449,436.57 |
| Robert (2/9) | 299,624.25 |
| Norman (2/9) | 299,624.25 |
| Martin (2/9) | 299,624.25 |

The Joint Venture is treated as a partnership for tax purposes. IRC § 761(a); T.C. Opin., p. 44. A partner's basis for his or her partnership interest is increased under IRC § 705(a)(1)(A) by an amount equal to his or her distributive share of the partnership's taxable income. Thus, under the computations adopted by the Tax Court, as of the end of 1956 all of the male appellants should be assigned basis increases for their interests in the Joint Venture in the respective amounts set forth above.

In 1957 the Joint Venture was enjoined from further trading in Torbrook securities. Those securities became worthless in 1958, an event recognized by the IRS (See 6/2/75 Tr., p. 4), and the Joint Venture then terminated its affairs (T.C. Tr. 300).

Upon the 1958 termination of the Joint Venture the "economic reality" was that the partnership interest of each male appellant became worthless and was abandoned. See *Zeeman* v. *United States*, 275 F. Supp. 235, 67-2 USTC ¶ 9565 (S.D.N.Y. 1967), aff'd and remanded on another issue, 395 F.2d 861, 68-1 USTC ¶ 9406 (2d Cir. 1968); *Herman Axelrod*, 18 BTA 927 (1930), Acq. C.B. IX-2, 4.

An abandonment is not a sale or exchange. It is therefore not a capital transaction and Sydney, Robert, Norman and Martin sustained ordinary losses in 1958 pursuant to IRC § 165(c). *Gaius G. Gannon*, 16 T.C. 1134 (1951), Acq. C.B. 1951-2, 2; *Palmer Hutcheson*, 17 T.C. 14 (1951), Acq. C.B. 1951-2, 2; *Zeeman* v. *United States*, *supra; Axelrod, supra*, Rev. Rul. 70-355, C.B. 1970-2, 51. See *Larry E. Webb*, 23 T.C. 1035 (1955), Acq. C.B. 1955-1, 7. Compare Rev. Rul. 66-93, C.B. 1966-1, 165. The losses which should have been carried back to 1956 for the Rule 155 computations are thus at least as great as the above described increases in bases for the partnership interests.

At the June 2, 1975 Rule 155 computation hearing, the Tax Court indicated that it believed that the above cases are no longer controlling (6/2/75 Tr., p. 9). The Court was apparently concerned about *Andrew O. Stilwell*, 46 T.C. 247 (1966), which held that *Gannon* and *Hutcheson* were inapplicable where a withdrawing partner's share of partnership liabilities was assumed by another partner because (i) there was then a sale or exchange in that the withdrawing partner received consideration, in the form of relief from partnership liabilities, for his partnership interest; (ii) the decrease in the withdrawing partner's share of partnership liabilities was considered, under IRC § 752, a distribution of money; (iii) the withdrawing partner was thus considered to have received a cash distribution in liquidation of his partnership interest; and (iv) under IRC § 731(a), a liquidating distribution of money results in capital gain or loss to the extent of the difference between the money received and the withdrawing partner's basis for his partnership interest.

In the instant case there was no assumption of Joint Venture liabilities by anyone. Accordingly, *Stillwell* does not apply * and *Gannon* and *Hutcheson* require the 1958 losses on the abandonment of the Joint Venture interests to be characterized as ordinary losses eligible for carrybacks and carryforwards.

The Tax Court's refusal to take those carrybacks and carryforwards, into account in its computation of the deficiencies was a substantial error of law. It should be reversed.

---

* Please note that the Tax Court in *Andrew O. Stilwell, supra*, footnote 5 at 252, stated: "[W]e expressly refrain from deciding whether an absolute forfeiture would give rise to a capital or ordinary loss under the 1954 Code."

## ISSUE III

**$250,000 paid to the Joint Venture in 1956 by General Tire & Rubber Company is taxable as long-term capital gain.**

In 1955 the Joint Venture attempted to get control of A. M. Byers Co., Inc. ("Byers"). In 1956, after the Joint Venture abandoned that attempt (See T.C. Tr. 237, 261), it sold 25,000 Byers shares to the General Tire & Rubber Company. The consideration for that sale was (i) $250,000 paid pursuant to a July 3, 1956 option agreement granting the purchaser the right to exchange its stock and warrants for the 25,000 Byers shares and (ii) the stock and warrants which were exchanged shortly thereafter.

The $250,000 was reported as a long-term capital gain. The IRS, purportedly concerned because the July 3, 1956 option agreement also assigned rights to a patent application and did not allocate the $250,000, determined that the entire $250,000 is taxable as ordinary income. The Tax Court approved that determination because the $250,000 was not allocated.

An allocation of the $250,000 was not necessary. An amount paid for a subsequently exercised option to purchase stock is included in the amount realized (See *C.V.L. Corporation*, 17 T.C. 812, 815 (1951); *Helen E. Leatherbee, et al.*, 34 B.T.A. 196, 199 (1936)) and is thus considered long-term capital gain when the stock is a capital asset and a gain is recognized. With respect to the rubber bellows pump, since all substantial rights to the patent application were transferred under the July 3, 1956 option agreement, the portion of the $250,000 attributable to those rights is also taxable as long-term capital gain.

Code Section 1235. See *Ross* v. *United States*, 75-1 USTC ¶ 9183 (W.D. Wash. 1974).

Accordingly, since the $250,000 was paid for a subsequently exercised option to purchase stock and for the transfer of all substantial rights to a patent application and since long-term capital gain is applicable in both instances, the $250,000 was correctly reported. The Tax Court's holding should be reversed because it was a substantial error of law.

## ISSUE IV

**Appellant Martin Rodman, who became a 2/9 venturer in the Joint Venture on November 5, 1956, cannot be retroactively taxed on pre-November 5, 1956 Joint Venture income.**

The Tax Court summarized its analysis and holding on this significant "first impression" legal issue—*i.e.*, whether a *new* partner can be assigned a *retroactive* interest in a partnership's profits and losses—as follows (T.C. Opinion, pp. 46, 47, 48):

> "Respondent [IRS] contends that it was the intention of the parties under the November 5, 1956 agreement to retroactively amend the joint venture agreement to allow Martin Rodman to share in the full year's profits and losses of the joint venture. He points to the partnership return for 1956 in support of this contention. Martin Rodman, on the other hand, testified that it was the intention of the parties to have his share of the profits and losses of the joint venture begin with his entry thereto.

In the partnership return, Martin Rodman was allocated 22 percent of the losses of the joint venture for the full year 1956, in addition to his share of the net long-term capital gains covering the same period. He filed his individual return on that basis. The loss reported by the joint venture has been wiped out by virtue of our determination above that the $900,000 note to Aurele Brisson was incorrectly included in the joint venture's cost of goods sold. Respondent would tax Martin on the same proportionate share of such income.

We are compelled to agree with respondent. In the face of the partnership return, we are unable to accept Martin Rodman's statement that the other partners intended only to have him share in the profits and losses of the joint venture from the date of his entry. Both Martin Rodman and the other partners clearly reflected their understanding of the agreement by reporting their respective distributive shares of the joint venture's income and loss in accordance with the partnership return. There was never any suggestion by Martin Rodman that the understanding of the parties with respect to the November 5, 1956 agreement was ever altered between that date and the filing of the partnership return.

In accordance with the above, we hold that Martin Rodman must compute his distributive share of the joint venture items described in section 702(a) on the basis of the full taxable year. The items described in section 702(a), however, must first be reduced by any amount attributable to the withdrawing partner, Ornstein, under section 706(c)(2)(i)." *

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* The only amount deemed attributable to Ornstein by the IRS and the Tax Court's Decisions was 25% of the $250,000 paid by General Tire & Rubber Company.

The above analysis discloses that both the IRS and the Tax Court were swayed by the fact that 2/9 of the Joint Venture's reported 1956 loss was claimed, apparently by mistake, as a deduction on Martin's 1956 return. Instead of adjusting the partnership percentages to eliminate the retroactive claim, the IRS and the Tax Court seem to have concluded that the situation required a quid pro quo. That conclusion, embodied in the Tax Court's December 19, 1973 Opinion, opened a huge loophole for shelter promoters that has been widely publicized during the past two years.

In the Spring 1974 edition of the American Bar Association Tax Section publication, *Tax Lawyer*, a summary of this case was introduced as follows (p. 524):

> "17. *Partnerships: Retroactive Allocations*
>
> The recent case of *Norman Rodman*, 32 TCM 1307 (1973), has generated much interest in the partnership tax area. Some feel that the case stands for the general proposition that partnership items attributable to the portion of the year prior to a new partner's admission to the partnership can be retroactively allocated to him."

The January 11, 1974 edition of the *Tax Coordinator* described the new loophole in the following manner (pp. 6 and 7):

> "*New partner can be taxed on earnings before he become partner. . .*
>
> The admission of a new partner can create a tax-saving opportunity under a new tax Court case. Here's the story.
>
> The Code and regulations provide that a partner's share of partnership income and losses is determined by the partnership agreement. And the partnership agreement can be changed, modi-

fied, etc., retroactively so long as this is done before the due date of the partnership return. * * * Thus the partners can generally wait until the figures are in after the partnership's year ends before finally deciding on their sharing ratios for that year. The Tax Court has just upheld the Treasury's view that this enables the partners to allocate to a last minute new partner a share of the *full year's partnership* income including income earned by it before he become a partner.

* * * * *

*Observation*: Here the Treasury argued that partnership profits earned before a person becomes a partner can be allocated to him, presumably because the son had the funds to pay the heavy additional tax whereas the other partners apparently didn't. But this Treasury view may boomerang in other situations."

In "Retroactive allocations to new partners: An analysis of the area after *Rodman*", *The Journal of Taxation* (March 1974, p. 166), the authors applauded the Tax Court's approval of the retroactive planning device and explained its application to shelters * as follows (footnotes are omitted):

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* In its September 2, 1975 "Overview of Tax Shelters", a Joint Committee on Internal Revenue Staff Report observed:

> "the existence of tax shelters has become a focal point for disenchantment with the fairness of the Federal tax system. When the great majority of taxpayers perceive that a few wealthy taxpayers escape tax almost completely in return for making investments which may not even be sensible from an economic standpoint, it becomes hard to convince them that the tax system is truly fair and progressive."

A final decision for the IRS on this issue would allow more wealthy taxpayers to avoid more taxes. It is submitted that the IRS position is unconscionable.

"Promoters of syndicates in real estate and other shelters commonly represent to [potential new partners] * * * that shares of deductible expenses previously incurred by the partnership will be allocated to them, retroactively to the first of the tax year. * * * Commentators have clashed sharply over whether the Code permits such retroactive allocations.

* * * * *

As late as the winter of 1972 the Service had not announced a position on retroactive allocations. Now the Commissioner has argued in *Rodman* * * * that * * * the parties intended to retroactively amend the partnership agreement to allow the new partner 'to share in the full year's profits and losses of the joint venture'.

The Commissioner's surprising litigation posture becomes more understandable in light of the * * * facts [the claim of 2/9 of the 1956 reported loss by Martin].

* * * * *

to some writers retroactive allocations smacked of "trafficking" in previously incurred tax deductions.

In summary, the entire area was quite unsettled until the *Rodman* decision.

* * * * *

*Rodman* opens the door for admission by capital contributions of new partners who will share losses (or profits) for the entire partnership taxable year according to the last modification of the partnership profit or loss ratio prior to or on the due date of the partnership return.

* * * * *

*Rodman is the first decision to expressly sanction retroactive allocations to new partners. The fact that it is a memorandum decision* may only reflect that it involved multiple issues or that the record was overly bare after the passage of 17 years and the death of several of the principals. On the other hand, it *might reflect a desire by the Tax Court to deemphasize a hot issue.* Certainly the Service may be expected to later reassess and possibly attempt to shift its position" (Emphasis added).

"Retroactive Allocations Among Partners: The *Rodman* Decision", a thoughtful article in the June 1974 edition of *Taxes*, provides in pertinent part * as follows (p. 325):

"One of the more currently controversial issues in partnership taxation is the question of whether or not partnership tax losses incurred throughout the year may be allocated to a partner who, late in the year, contributes capital to the partnership in exchange for a partnership interest. These deductions are very often offered as a major inducement to the prospective investor in a tax shelter offering.

The question of retroactive allocations has been the subject of much discussion (and differing views) among the commentators and, until *Rodman*, the question of a retroactive allocation to an incoming partner had not been squarely faced by a court. However, *the government's position and the Tax Court's conclusion in Rodman seem only to further muddy an already murky area of the law.* (Emphasis added)

* * * * *

---

* Footnotes are omitted.

*Rodman* is the first case dealing specifically with retroactive allocations involving a newly admitted partner. In *Smith* [331 F.2d 298, 64-1 USTC ¶ 9390 (7th Cir. 1964)] the court held effective an oral amendment to the partnership agreement to retroactively allocate the entire income to Partner A who agreed to buy out Partner B. * * * *The court* in substance *held that the re-allocation among existing partners* had substantial economic effect. The other case often cited by commentators as at least appearing to touch on the question of retroactive allocations is *Town and Country Plymouth, Inc.* v. *United States.* [67-2 USTC ¶ 9680 (D.C. Col. 1967)]. While some writers have argued that this case supported retroactive allocations, * * * examination of the Schedules K and M attached to the 1961 partnership return in question discloses that * * * *Town and Country Plymouth* did not sanction the retroactive allocation of losses to an incoming partner. (Emphasis added)

* * * * *

If the ability to amend a partnership agreement to retroactively change a partner's share of taxable income or loss is viewed as limited to those partners who were partners when the income was earned or the deductions incurred, then there would be no conflict with Section 706(c)(2) requiring an allocation of taxable income or loss when a partner's interest is sold, exchanged or reduced (i.e., by admission of new partners).

Also the conflict with the *Platt* [207 F.2d 697, 53-2 USTC ¶ 9560 (7th Cir. 1953)], *Phillips* [233 F. Supp. 59, 64-2 USTC ¶ 9671 (D.C. Tex. 1964)] and *Haass* [55 T.C. 43 (1970)] reasoning * also

* Those cases denied intangible drilling deductions to taxpayers who paid for interests in oil leases but did not own the interests when the deductions were incurred.

disappears when this approach is taken, and 'trafficking' in previously incurred tax deductions would become less of a concern for the Treasury as well as for the tax adviser asked to bless the marketing of those deductions."

At the June 2, 1975 Rule 155 Tax Court hearing, the IRS counsel attempted to limit the scope of the retroactive holding. The Court's response shows no limitation was intended or included in the Tax Court Opinion (6/2/75 Tr., pp. 20 and 21):

"Mr. Goldstein: Your Honor, in that regard I would like to say that there has been a good deal written about the opinion in this case.

The Court: I know it. It's been—

Mr. Goldstein: And I would comment that the respondent's position in this case was very narrowly confined to the set of facts in this case. I have received all kinds of inquiries from members of the Bar as to what was behind this case in tax planning.

The Court: Well, whether you can retroactively reallocate the income after the end of the year—is that what—

Mr. Goldstein: Well, we took the caveat all the way through that there could not be an assignment of income here.

The Court: Well, I—

Mr. Goldstein: And we tried to very carefully word our position and *I think that the Bar is interpreting it a great deal more broadly than respondent has.*

The Court: Well, *that serves you right.*" (Emphasis added)

The holding is wrong. Under IRC § 706, pertinent Treasury Regulations and applicable case law a withdrawing partner (such as Ornstein) is required to include in *his* taxable income his share of partnership profits up to the time of his withdrawal.* *George F. Johnson*, 21 T.C. 733 (1954). See *Leff* v. *Commissioner*, 235 F.2d 439, 56-2 USTC ¶ 9809 (2d Cir. 1956). In *George F. Johnson*, *supra*, Judge Opper explained (at pp. 738 and 739):

> "It is by now well settled that a withdrawing partner is chargeable with ordinary income on his share of the partnership profits, whether currently distributed or not, up to the time of his withdrawal. *LeSage* v. *Commissioner*, (C.A. 5) 173 F.2d 826; *Louis Karsch*, 8 T.C. 1327. This is so notwithstanding that he sells his interest to the continuing partner."

The Joint Venture was formed in 1955. Ornstein, Sydney, Robert and Norman each had 25% interests. In November 1956 Ornstein withdrew from the Joint Venture and his successor was Martin. Pursuant to a November 5, 1956 agreement, the interests of the venturers and their respective interests *from that date forward* were:

| | |
|---|---|
| Sydney | 1/3 |
| Robert | 2/9 |
| Norman | 2/9 |
| Martin | 2/9 |

Treasury Regulation 1.706-1(c)(2)(ii) provides that a successor to a partner whose entire interest was liquidated is to "include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year."

* The record does not reveal whether, and if not why not, the IRS has tried to tax Ornstein on the Joint Venture's alleged income for the January 1-November 3, 1956 period.

During 1956 Martin was a venturer for 57 days (26 days in November and 31 days of December). Therefore, his pro rata part of the Joint Venture's 1956 unreported income, if any, is .03558 (57/366 x 2/9).

The Tax Court's holding that Martin should be taxed on a full 2/9 of the Joint Venture's alleged 1956 unreported income is a substantial error of law which provides a new tool for those who spend their time helping the rich avoid their fair share of the Nation's tax burden. Moreover, the Court's holding completely ignores the cardinal rule enunciated by the Supreme Court that the dominant purpose of the revenue laws "is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid." *Helvering* v. *Horst*, 312 U.S. 112. The holding should be reversed.

## ISSUE V

**If it is ultimately determined that Norman Rodman, Martin Rodman, Robert Rodman and Sydney Newman had unreported 1956 income from the Joint Venture, appellants Arlene Rodman, Phyllis Rodman, Gertrude Rodman and Dorothy Clifford Newman are "innocent spouses" not liable for attributable taxes and interest due to Internal Revenue Code §6013(e).**

Due to the "joint and several" liability of joint income tax returns (IRC § 6013(d)(3)) and the Tax Court's refusal to grant Arlene, Phyllis, Gertrude and Dorothy "innocent spouse" status under IRC § 6013(e), the Tax Court's Devisions impose liabilities (before interest which will exceed 100%) as follows:

| | |
|---|---|
| Arlene | $193,029.85 |
| Phyllis | 198,852.64 |
| Gertrude | 199,365.79 |
| Dorothy | 358,892.73 |

The "innocent spouse" provision was suggested to Congress by the following Tax Court comment in *Louis M. Scudder*, 48 T.C. 36, 41 (1967):

> "Although we have much sympathy for petitioner's unhappy situation and are appalled at the harshness of this result in the instant case, the inflexible statute leaves no room for amelioration. It would seem that only remedial legislation can soften the impact of the rule of strict individual liability for income taxes on the many married women who are unknowingly subjected to its provisions by filing joint returns."

The remedial legislation suggested by the Tax Court was enacted on January 12, 1971 when new subsection (e) was added to IRC § 6013. That subsection, which covers all open cases, provides:

> "(e) *SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.—*
>
> (1) *IN GENERAL.*—Under regulations prescribed by the Secretary or his delegate, *if—*
>
> (A) *a joint return has been made* under this section for a taxable year *and on such return there was omitted from gross income an amount* properly includable therein which is *attributable to one spouse* and which is *in excess of 25 percent of the amount of gross income stated in the return,*
>
> (B) the other spouse establishes that in signing the return he or she did not know of, and had no reason to know of, such omission, and
>
> (C) taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted

from gross income and taking into account all other facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such omission, then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent that such liability is attributable to such omission from gross income.

(2) *SPECIAL RULES.*—For purposes of paragraph (1)—

(A) the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws, and

(B) the amount omitted from gross income shall be determined in the manner provided by section 6501(e)(1)(A)." (Emphasis added)

It is significant that § 6013(e)(2)(B) provides that for purposes of § 6013(e)(1) "the amount omitted from gross income" shall be determined pursuant to § 6501 (e)(1)(A). §6013(e)(2)(B) does *not* say that the definition of "gross income", for purposes of § 6013(e)(1), is to be determined under § 6501(e)(1)(A).

§ 6501(e)(1)(A) gives the IRS additional time to investigate tax returns when a taxpayer's failure to report one or more substantial taxable items puts the IRS at a special disadvantage—*i.e.*, it is difficult for the IRS to discover the omission in the usual three-year period. See *Colony, Inc.* v. *Commissioner*, 357 U.S. 28, 58-2 USTC ¶ 9593 (1958). It provides:

"(e) *SUBSTANTIAL OMISSION OF ITEMS.*—
Except as otherwise provided in subsection (c)—

(1) *INCOME TAXES.*—In the case of any tax imposed by subtitle A—

(A) *GENERAL RULE.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

(i) In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item." (Emphasis added)

§ 6501(e)(1)(A)(ii) thus provides that the "amount omitted from gross income" does not include items "disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item".

The purpose of that qualification is to give taxpayers the protection of the 3-year statute of limitations when the IRS is on notice of unreported income items.

The purpose of § 6013(e)(2)(B) is obviously to deny "innocent spouse" status when a spouse is on notice of unreported items because said items are disclosed in the joint return or in a statement attached to the joint return in a manner adequate to apprise the spouse of the nature and amount of the unreported item. § 6013(e)(2)(B) has no other purpose. Attempts by the IRS and the Tax Court to read other facets of § 6501(e)(1)(A) into § 6013(e) are improper.

Partnership returns are filed with the IRS. A body of law giving taxpayer-partners the benefit of the 3-year statute of limitations when disclosure is made on partnership returns has developed. Cases hold that for purposes of § 6501(e)(1)(A)(ii) the IRS is apprised of items disclosed in a partnership return even though there is no disclosure in a taxpayer-partner's return. See *Jack Rose*, 24 T.C. 755, 768-769 (1955); *Elliott J. Roschuni*, 44 T.C. 80 (1965).

Those cases should *not* apply in the innocent spouse area since a non-partner spouse who otherwise qualifies for innocent spouse status (no knowledge of or benefit from the omission) by definition could not have been apprised of items *disclosed to the IRS* in the partnership return. The innocent spouse would never see the partnership return.

The Tax Court's reasoning and holding on this issue are as follows (T.C. Opinion, pp. 51, 52 and 53):

> "The final issue for our determination is whether petitioners Arlene Rodman, Phyllis Rodman, Gertrude Rodman and Dorothy Clifford New-

man are entitled to relief from liability under section 6013(e) for any of the years to which such section applies.

Section 6013(e) provides certain conditions under which an innocent spouse will be relieved of any income tax liability attributable to an omission from gross income by the other spouse of an amount in excess of 25 percent of the amount of gross income stated in the joint return.

When section 6013(e) speaks of a 25 percent omission from gross income, it does not refer to an omission from gross income which results from an error in computing the cost of goods sold. Section 6013(e)(2)(B) incorporates the rules of section 6501(e)(1)(A) in determining whether a 25 percent omission has been made, and under section 6501(e)(1)(i), an error in the cost of goods sold is not the equivalent of an omission from gross income within the meaning of such term. See *Colony, Inc.* v. *Commissioner*, 357 U.S. 28 (1958).

The characterization of "gross income" on the partnership level is determinative of "gross income" on the partner level since the partnership return must be read as an adjunct with an individual partner's return in determining the total gross income stated in the individual's return. *L. Glenn Switzer*, September 17, 1954, remanding per stipulation 20 T.C. 759 (1953); *Nadine I. Davenport*, 48 T.C. 921 (1967). Thus, although our determination that the $900,000 note to Aurele Brisson was improperly included in the joint venture's cost of goods sold in 1956 effectively increased the gross income of petitioners for such year, such increase is not due to an omission from gross income within the meaning of section 6013 (e).

None of the other years before the Court involve a 25 percent omission. Accordingly, we hold that petitioner wives are not enttiled to relief under section 6013(e) for any of the years involved.

Finally, even if there had been an omission of 25 percent of gross income in any of the years involved, the petitioner wives have failed to establish that they meet the other prerequistites (sic) of section 6013(e). Accordingly, we are unable to grant them relief under that section. *Jerome J. Sonnenborn*, 57 T.C. 373 (1971); *Nathaniel M. Stone*, 56 T.C. 213, 337 (1971)."

The above discloses that the Tax Court (1) erroneously concluded that § 6013(e)(2)(B) incorporates the rules of § 6501(e)(1)(A)(i) instead of just § 6501(e)(1)(A)(ii); 2 improperly concludes that partnership returns never seen by innocent spouses "must be read as an adjunct" to joint returns for purposes of testing whether or not innocent spouses were aware of omissions in excess of 25%; and (3) concedes that its determination regarding the $900,000 note "effectively increased the gross income of petitioners".

*L. Glenn Switzer*, 20 T.C. 759 (1953), and *Nadine I. Davenport*, 48 T.C. 921 (1967), are the Tax Court's authorities for its holding that the partnership return "must be read as an adjunct" with the joint return in determining whether an "amount omitted" from an innocent spouses's joint return was "gross income" for purposes of § 6013(e)(1)(A). *Switzer* involved an argument similar to the IRS position. In *rejecting* that position, Tax Court Judge Rice called it a "fallacy" (20 T.C. at 768). *Davenport* concerned an IRS attempt to use a 6-year statute of limitations instead of the 3-year period. In holding that, for statute of limitations purposes, a tax-

payer-wife was entitled to the 3-year period where the IRS received a partnership return, the Tax Court held (48 T.C. at 928):

> "a partnership return is to be considered together with an individual return in determining the total gross income stated in the individual return for the purpose of determining whether the 6-year statute of limitations is applicable. *Jack Rose*, 24 T.C. 755, 768-769 (1955). See also *Elliott J. Roschuni*, 44 T.C. 80 (1965), and *Genevieve B. Walker*, 46 T.C. 630, 637-638 (1966)."

The two cases are not controlling. As far as the spouses are concerned the reported Joint Venture losses were their "gross income". The unreported shares of Joint Venture income, if any, were omissions within the meaning of § 6013(e)(1)(A).

The Tax Court's alternative holding on this issue in the instant case is that the two widows and the two wives failed to carry their burden, apparently because they didn't testify in October 1972 when they were unavailable because of age and illness.

The amounts of alleged unreported 1956 income are far in excess of 25% of the amounts of gross income stated in the joint returns. Moreover, it is the appellants' position that the "facts and circumstances as revealed in the entire record" establish that these women were not members of the Joint Venture, had no relation to the transactions involved and are qualified innocent spouses. (See *Sam Shapolsky*, T.C. Memo. 1972-62, 31 TCM 260 (1972)). However, because the appellants were concerned that the failure of the wives to testify could cause a burden of proof problem, a Motion for Leave to Open Record for presentation of evidence of the wives was filed with the Tax Court on October 31, 1973.

On November 9, 1973 the IRS filed with the Tax Court an Objection to appellants' Motion because the IRS allegedly believes, among other things, that attempts "to engage in piece-meal litigation are not conducive to an orderly presentation of the case." On November 13, 1973 the Tax Court denied the appellants' Motion.

The Tax Court's refusal to accept testimony from the spouses and its holding that unreported partnership income is not "gross income" under § 6013(e) fly in the face of the purpose of the innocent spouse provision. The sole purpose of the provision is to remedy inequities such as the ones involved herein which result from the imposition of joint liability. It has been held that the provision is to be construed and applied liberally in favor of those whom the statute was designed to benefit. *Allen* v. *Commissioner*, 514 F.2d 908, 75-2 USTC ¶ 9540 (5th Cir. 1975). In *Dakil*, 496 F.2d 431, 74-1 USTC ¶ 9420 (10th Cir. 1974), when the court refused to hold a spouse liable for the omitted income of her deceased husband because it would have been inequitable to do so, the court concluded that even "a tax collector should have some heart".

The IRS objection to the presentation of additional innocent spouse evidence because of an alleged desire for a so-called "orderly presentatiton" was a heartless act. The Tax Court's November 13, 1973 ruling approving that objection was contrary to the intent of Congress.

The House Committee Report (Committee Report on P.L. 91-679) on the innocent spouse provision explained that Congress was enacting Section 6013(e) "to bring government tax collection practices into accord with basic principles of equity and fairness". Equity and fairness require Arlene, Phyllis, Gertrude and Dorothy to be given an opportunity to explain why they should be protected from the Tax Court's harsh result.

The Court's holding is a substantial error of law which may adversely affect many similarly situated spouses of partners. It should be reversed.

## ISSUE VI

**The Joint Venture's contested 1956 and 1957 business deductions should be partially allowed pursuant to the rule of *Cohan* v. *Commissioner*, 39 F.2d 540, 2 USTC ¶ 489 (2d Cir. 1930).**

Although the Joint Venture received $2,574,903.34 for Torbrook shares it sold to the public in 1956 (T.C. Opin., p. 11) and reported $150,301.97 of 1957 gross receipts,* the IRS and the Tax Court apparently believed that said income was earned without necessary deductions. The IRS disallowed (with the Tax Court's approval) all 1956 sales expenses, all 1957 travel and investigation expenses, all 1957 commissions, virtually all 1957 sales expenses, virtually all 1957 legal and accounting expenses and approximately 70% of 1956 travel and investigation expenses.

The record shows that substantiation was (1) relied upon by Mr. Elliott when he prepared the Joint Venture's returns (T.C. Tr. 301-306, incl.), (2) compiled and cross-indexed for the IRS during 1958 and 1959 and (3) subsequently lost during repeated investigations and confusion generated by deaths of individuals involved in the early stages of the case.

*Cohan* v. *Commissioner*, 39 F.2d 540, 2 USTC ¶ 489 (2d Cir. 1930), the oft-cited Opinion of the great Learned

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* The relatively small amount is because Joint Venture trading in Torbrook was enjoined in March 1957 (T.C. Ex. 49).

Hand of this Court, is authority for reversing the Tax Court's approval of the blanket disallowances. Judge Hand discussed the importance of estimating George M. Cohan's expenses as follows:

> "In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it

> were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence."

The record herein shows that huge amounts of income were earned, trips were made to Canada, stock was bought, stock was sold, agreements were prepared and executed and professional services were performed. The Tax Court's ruling that nothing was spent is inconsistent with the reporting of nearly $3,000,000.00 of income.

That ruling is a substantial error of law. The Tax Court should be instructed to reconsider the evidence so it can approximate how much of the Joint Venture's 1956 and 1957 contested business deductions should be allowed.

## CONCLUSION

The relief requested by appellants is as follows:

1. Appellants request this Court to reverse Tax Court holdings with respect to the following issues so:

   a. the $900,000 can be included in the basis of Torbrook shares bought and sold during 1956.

   b. "ordinary" loss carrybacks can be claimed for the 1958 worthlessness of Joint Venture capital interests owned by Norman, Martin, Robert and **Sydney.**

   c. the $250,000 paid to the Joint Venture in 1956 by General Tire & Rubber Company can be taxed as long-term capital gain.

   d. Martin's distributive share of the Joint Venture's 1956 income, if any, can be based on a .03558 interest.

e. the unreported 1956 Joint Venture income, if any, can be considered omitted income for purposes of the "innocent spouse" provision, I.R.C. § 6013(e)(1)(A).

f. testimony from the two widows and two wives can be presented on the innocent spouse issue.

g. the Joint Venture's contested 1956 and 1957 business deductions can be partially allowed pursuant to the rule of *Cohan* v. *Commissioner*, 39 F.2d 540, 2 USTC ¶ 489 (2d Cir. 1930).

h. Martin and Phyllis can claim loss carryforwards to 1959, 1960, 1961 and 1962 of the unused 1958 losses of Martin's capital interest.

2. Appellants request this Court to remand the case to the Tax Court with instructions to:

a. receive evidence with respect to (i) the sizes of the 1958 losses sustained by Norman, Martin, Robert and Sydney; (ii) the amounts of the respective carrybacks and carryforward losses; (iii) the "innocent spouse" issue; (iv) the Joint Venture's contested 1956 and 1957 business deductions; and (v) in the alternative, the value of the May 1956 debt.

b. recompute the respective deficiencies.

Respectfully submitted,

November 19, 1975

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# United States Court of Appeals
**FOR THE SECOND CIRCUIT**

No. 75-4211

Norman and Arlene Rodman, et al
Appellants

v.

Commissioner of Internal Revenue
Appellee

**AFFIDAVIT OF SERVICE BY MAIL**

Stephen Zedalis, being duly sworn, deposes and says, that deponent is not a party to the action, is over 18 years of age and resides at 47-19 194th Street Flushing, N.Y.

That on the 20th day of November, 1975, deponent served the within Brief for Appellants upon Scott P. Crampton Assistant Attorney General, Tax Division U.S. Department of Justice, Washington, D.C. 20530

Attorney(s) for the Appellee in the action, the address designated by said attorney(s) for the purpose by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in a post office official depository under the exclusive care and custody of the United States Post Office department within the State of New York.

Sworn to before me,

This 20th day of November 1975

Stephen Zedalis

William J. Bachman

WILLIAM J. BACHMAN
Notary Public, State of New York
N. 30-5137735
Qualified in Nassau County
Commission Expires March 30, 1976